**BILL #** SB 1176

**TITLE:** corporate tax credit; tuition organizations

**SPONSOR:** Martin

**STATUS:** As Amended by Senate Finance

**REQUESTED BY:** Senate

**PREPARED BY:** Steve Schimpp

# FISCAL ANALYSIS

**Description**

The bill would allow corporations to claim an income tax credit for contributions made to a School Tuition Organization (STO) that provides scholarships to children from families' whose income does not exceed 185% of the income level required to qualify a child for free or reduced price school lunches. The maximum credit allowed under the bill would equal the amount of the contribution if less than $10,000, or an amount preapproved by the Arizona Department of Revenue if more than $10,000. In addition, the amount of preapproved ($10,000+) credits would be capped at $10 million for calendar year 2006 and increase $5 million annually to a total statewide maximum of $55 million starting in calendar year 2015. Total statewide credits for contributions less than $10,000 would not be capped under the bill.

**Estimated Impact**

The JLBC Staff is unable to determine the fiscal impact of the bill with certainty. The bill would have 2 areas of possible fiscal impact: 1) the new tax credit would reduce state revenues from the corporate income tax, and 2) new STO scholarships would reduce the state's K-12 education costs if students attend private rather than public schools.

While it is difficult to determine the bill's precise fiscal impact in advance, we have attempted to determine the feasibility of the bill being cost neutral to the General Fund. Based on the experience of another state, we have estimated first year (FY 2007) credits of $5 million for the purposes of this analysis. At this level of credits, approximately 1,000 students would have to be diverted from the public school system to generate sufficient Department of Education Basic State Aid savings to offset the cost of the credits. This amount would equal 0.1% of public school enrollment and 2.3% of private school enrollment. While not guaranteed, this result seems plausible.

There is a possibility, however, that the bill could have a net cost in its first years. Total first year credits potentially could be substantially higher than $5 million because the bill would not cap total credits. If so, private school enrollments would have to increase by more than 2.3% in year one of the bill. For example, if $15 million in credits are claimed in the first year, private school enrollment would have to increase by 3,000 students, or 6.9%. A one-year increase of this magnitude would be more difficult to achieve.

DOR estimates that the bill would generate $10 million in tax credits in year 1, although DOR believes that the revenue loss would first occur in FY 2006 rather than FY 2007. DOR estimates that total statewide tax credits would increase to $20 million in FY 2007 and thereafter by $5 million each year until they reached the $60 million level in FY 2015. DOR did not attempt to estimate K-12 education savings for the bill.

The bill also presents certain timing issues that could possibly result in a loss of corporate income tax revenues in FY 2006 before Basic State Aid savings began to occur in FY 2007. Corporations could begin to reduce their tax payments in FY 2006, while public school enrollment would not decline until FY 2007.

**Analysis**

The fiscal impact of the bill would depend on several factors described below.

**Analysis** (Continued)

Corporate Donations

JLBC Staff cannot predict levels of corporate donations under the bill with certainty because they would depend on decisions by individual corporations and because Arizona's corporate income tax collections are volatile. A similar program in Pennsylvania, however, received $19 million in corporate income tax pledges during its first year when contributions were capped at $20 million. This equaled about 1.2% of Pennsylvania's total $1.6 billion in corporate income tax collections for the year. Arizona's corporate income tax collections have ranged from about $315 million in FY 2002 to about $500 million per year during much of the 1990's. The current FY 2005 projection is $652 million. As a starting point for our analysis, we have assumed that first year credits would equal $5 million, which would be equivalent to about 0.8% of projected FY 2005 revenues.

As noted above, DOR estimates that the bill would result in first year credits of $10 million and that the first year revenue loss would occur in FY 2006 rather than FY 2007. The tax credit becomes effective for the tax year (TY) beginning January 1, 2006. Corporations make estimated tax payments throughout the year. These estimated payments generally are then applied to the corporation's total tax liability when the corporation files its tax return, generally in April of the following year. For example, TY 2006 estimated payments generally would be incorporated into the April 2007 tax filing.

In this circumstance, DOR assumes that corporations would adjust their April and June 2006 estimated payments downward by $10 million for their STO contributions made between January and June 2006. This "scoring" methodology is different from DOR's standard costing of a tax credit's fiscal impact. When determining the fiscal impact of tax credits, DOR typically does not make this "estimated payment" adjustment. Instead, they usually assume that the fiscal impact of a tax credit will begin in April following the first full year of implementation.

Scholarships Not Resulting in Savings

A second uncertainty is projecting the number of students who would transfer from the public school system because of the bill. A savings would not be realized for Kindergartners who would have enrolled in private school without scholarships or public school pupils who would have transferred to private school with or without the bill ("natural transfers"). JLBC Staff cannot predict with certainty the proportion of scholarships that would be awarded under the bill to "new" public school transfers versus pupils in the two "non-saving" categories. For FY 2007, however, we currently estimate that about 1,022,600 Average Daily Membership (ADM) pupils would attend public schools apart from the bill and that 45,000 would attend private schools and 25,000 would be home schooled. We also estimate that about 79,400 new pupils will enroll in Kindergarten in FY 2006 with or without the bill, of which about 4%, or 3,200 would enroll in private school apart from it.

The number of "natural transfers" that would receive scholarships under the bill could be relatively small, since the bill would provide scholarships only to pupils whose family income does not exceed 185% of the federal poverty level. (This equates to $34,900 for a family of four, however, language in the bill could be interpreted as allowing income levels up to $64,500 for a family of four to qualify, which would be 185% of 185% of federal poverty level.) Depending on the bill's interpretation, the number of such pupils who could afford to transfer to private schools without scholarships, therefore, could be limited. About 47% of all public school pupils in Arizona currently qualify for free or reduced price school lunches.

Assumptions for Savings and Scholarships per Student

For FY 2005, each pupil added to the statewide K-12 ADM count costs the state General Fund about $4,700 in operating expenses. Based on past trends, JLBC Staff estimate that this amount will increase 2.5% annually in future years. The state General Fund, therefore, would save an average of about $5,000 for each pupil who transferred out of public schools because of the bill in FY 2007. For FY 2008 and FY 2009 the estimated per pupil savings would equal about $5,125 and $5,250, respectively. For FY 2016 (upon full implementation) we estimate that the average per pupil state savings would be $6,250.

Data compiled by DOR indicates that the average scholarship awarded by STO's for CY 2003 was $1,219, or $76 higher than for CY 2002. Under the bill, the JLBC Staff therefore assumes that the average STO scholarship would increase $76 per year, resulting in an average per pupil scholarship of $1,523 in FY 2007, $1,599 in FY 2008 and $1,675 in FY 2009. The bill would permit individual scholarships of up to $4,700 in FY 2006, increasing $100 annually thereafter. STO's indicate, however, that they currently try to maximize the number of pupils receiving scholarships and typically require parents to pay at least a portion of their child's tuition costs. Available data on private school tuition indicates that tuition for elementary schools currently averages about $3,700 per pupil and high school tuition averages about $5,500 per pupil.

**Analysis** (Continued)

As noted above, the "starting point" estimate for corporate donations to STO's for FY 2007 is $5 million. The bill would require STO's to use at least 90% of this total for scholarships that year, so at least $4.5 million would be available for scholarships under this scenario. This would allow STO's to award about 2,950 scholarships for FY 2006 if the average scholarship amount was $1,523 per pupil, as described above.

<u>School Facilities Board Costs</u>

The bill potentially could reduce School Facilities Board (SFB) costs for new school construction and building renewal pursuant to A.R.S. § 15-2041 and A.R.S. §15-2031, which could help offset the cost of tax credits under the bill. New school construction costs would decrease if the SFB approved fewer new schools because of reduced enrollment growth under the bill. This would reduce SFB building renewal costs as well because fewer school buildings would require funding under that formula.

The amount and timing of new construction and building renewal savings under the bill is difficult to predict because only growing school districts with projected space deficiencies qualify for new schools and the proportion of pupils who would leave such districts versus all other districts under the bill is unknown. The timing of any potential savings in SFB-related costs under the bill likewise is difficult to predict because new schools are approved through a multi-year process that would not be immediately affected by the bill.

<u>"Cost Neutral" Estimates</u>

The JLBC Staff estimates that the bill would be "cost neutral" in FY 2007 if corporations donated $5 million to STO's and 1,000 students did not attend public schools because of the bill (1,000 students x $5,000 estimated savings per student = $5 million). This amount is equivalent to 0.1% of public school enrollment and 2.3% of private school enrollment.

If corporations donated $60 million per year upon full utilization of the bill (DOR's estimate) and this level was achieved starting in FY 2016, we estimate that about 9,600 cumulative "transfer" students would be required in order for the bill to be cost neutral (9,600 x $6,250 estimated savings per student in FY 2016 = $60 million). This would represent 1% of public school enrollment and 21% of private school enrollment over 10 years.

It is possible that savings from Basic State Aid may not be immediately achieved in the year that a public school student transfers to a private school. The bill does not prohibit school districts from including transferred pupils in their ADM counts after they transferred. Non-growing districts can continue to receive Basic State Aid for transferred pupils for 1 year, since they receive Basic State Aid funding based on their *prior* year rather than *current* year ADM counts.

As assumed by DOR, it is possible that under the bill corporations would reduce their corporate income tax "estimated payments" during FY 2006 instead of waiting until FY 2007 to claim a credit for contributions made to STO's during FY 2006. If this occurred, an offset for the lost corporate income tax revenue in FY 2006 would not appear until FY 2007, since students would not be able to receive scholarships under the bill that would enable them to transfer out of public schools until FY 2007. This potentially could cause the bill to have a fiscal impact in FY 2006 due to a corporate income tax revenue loss that year without Basic State Aid savings being available for that year to offset the revenue loss.

**Local Government Impact**

K-12 equalization funding to local school districts and charter schools would be lower under the bill than under current law because they would serve fewer pupils. The amount of funding loss per year, however, would depend on the number of existing public school pupils receiving scholarships each year under the bill versus the number of scholarships granted to "non-saving" pupils, which cannot be predicted.

Funding losses for most school districts would reduce General Fund costs rather than "local share" tax rates, since the latter are affected only by changes in tax rates and property values and neither of them would be affected by the bill. This would not be the case for "non-state aid" districts, however, because reductions in their ADM counts could cause them to lower their K-12 "local share" tax rates, since those rates are usually based on enrollments. Non-state aid districts would not

**Local Government Impact** (Continued)

necessarily lower their tax rates under the bill, though, because they are required to levy a “local share” tax rate equal to at least 50% of the K-12 Qualifying Tax Rate (QTR) pursuant to A.R.S. § 15-992(B).

Public school enrollment losses under the bill also potentially could reduce the amount of local property tax funding generated by school districts for overrides (which are capped at levels that indirectly tied to enrollment counts), school bond issuances, and “Excess Utilities” and other costs that may be funded with local property tax revenues.

The bill also would affect the amount of “revenue sharing” monies that cities and towns would receive from the corporate income tax. Currently their revenue sharing monies each year include an amount equal to 15% of statewide corporate income tax revenues from two years prior. Since the bill would reduce net corporate income tax revenue starting in FY 2007, the bill would lower their “shared” revenue from the corporate income tax starting in FY 2009.

2/8/05